

PERFORMANCE TECHNOLOGIES INC \DE\  
Form 10-Q  
November 07, 2006

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549  
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FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the Quarter Ended September 30, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number 0-27460

PERFORMANCE TECHNOLOGIES, INCORPORATED  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction  
of incorporation)

16-1158413  
(I.R.S. Employer Identification No.)

205 Indigo Creek Drive, Rochester, New York  
(Address of principal executive offices)

14626  
(Zip Code)

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Registrant's telephone number, including area code: (585) 256-0200  
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Indicate by check mark whether the registrant (1) has filed all reports  
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of  
1934 during the preceding 12 months (or for such shorter period that the  
registrant was required to file such reports), and (2) has been subject to such  
filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated  
filer, an accelerated filer, or a non-accelerated filer. See definition of  
"accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange  
Act. (Check one): Large accelerated filer  Accelerated filer   
Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as  
defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the registrant's common stock was  
13,270,690 as of November 1, 2006.

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PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(unaudited)

ASSETS

	September 30, 2006	December 31, 2005
	-----	-----
Current assets:		
Cash and cash equivalents	\$ 11,793,000	\$ 11,803,000
Investments	23,425,000	21,150,000
Accounts receivable, net	8,189,000	9,523,000
Inventories	6,989,000	7,148,000
Prepaid income taxes	44,000	
Prepaid expenses and other assets	405,000	470,000
Deferred taxes	3,609,000	3,272,000
	-----	-----
Total current assets	54,454,000	53,366,000
Property, equipment and improvements, net	2,286,000	2,004,000

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Software development costs, net	3,383,000	3,182,000
Investment in unconsolidated company	248,000	248,000
Goodwill	4,143,000	4,143,000
	-----	-----
Total assets	\$ 64,514,000	\$ 62,943,000
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	\$ 1,438,000	\$ 1,836,000
Income taxes payable		244,000
Accrued expenses	4,956,000	4,438,000
	-----	-----
Total current liabilities	6,394,000	6,518,000
Deferred taxes	1,252,000	1,138,000
	-----	-----
Total liabilities	7,646,000	7,656,000
	-----	-----
Stockholders' equity:		
Preferred stock - \$.01 par value; 1,000,000 shares authorized; none issued		
Common stock - \$.01 par value; 50,000,000 shares authorized; 13,260,038 shares issued	133,000	133,000
Additional paid-in capital	14,642,000	13,903,000
Retained earnings	42,217,000	42,601,000
Treasury stock - at cost; 6,235 and 171,757 shares held at September 30, 2006 and December 31, 2005, respectively	(124,000)	(1,350,000)
	-----	-----
Total stockholders' equity	56,868,000	55,287,000
	-----	-----
Total liabilities and stockholders' equity	\$ 64,514,000	\$ 62,943,000
	=====	=====

The accompanying notes are an integral part of these consolidated financial statements.

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME  
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	-----	-----	-----	-----
Sales	\$10,828,000	\$12,343,000	\$36,048,000	\$36,302,000
Cost of goods sold	5,615,000	6,153,000	17,715,000	18,531,000
Non RoHS inventory charge (Note C)			801,000	
	-----	-----	-----	-----
Gross profit	5,213,000	6,190,000	17,532,000	17,771,000
	-----	-----	-----	-----
Operating expenses:				
Selling and marketing	1,581,000	1,342,000	4,404,000	4,187,000

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Research and development	2,561,000	2,677,000	8,342,000	7,550,000
General and administrative	1,452,000	1,131,000	4,198,000	3,658,000
Restructuring charges (Note H)	792,000	53,000	1,786,000	249,000
Total operating expenses	6,386,000	5,203,000	18,730,000	15,644,000
(Loss) income from operations	(1,173,000)	987,000	(1,198,000)	2,127,000
Other income, net	385,000	333,000	1,090,000	958,000
(Loss) income before income taxes	(788,000)	1,320,000	(108,000)	3,085,000
Income tax (benefit) provision	(408,000)	383,000	(346,000)	895,000
Net (loss) income	\$ (380,000)	\$ 937,000	\$ 238,000	\$ 2,190,000
Basic (loss) earnings per share	\$ (.03)	\$ .07	\$ .02	\$ .17
Diluted (loss) earnings per share	\$ (.03)	\$ .07	\$ .02	\$ .17
Weighted average number of common shares used in basic earnings per share	13,252,012	12,872,126	13,178,107	12,848,264
Potential common shares		207,314	166,900	276,238
Weighted average number of common shares used in diluted earnings per share	13,252,012	13,079,440	13,345,007	13,124,502

The accompanying notes are an integral part of these consolidated financial statements.

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(unaudited)

	Nine Months Ended September 30,	
	2006	2005
Cash flows from operating activities:		
Net income	\$ 238,000	\$ 2,190,000
Non-cash adjustments:		
Depreciation and amortization	1,713,000	1,838,000
Tax benefit from stock option exercises	231,000	143,000
Stock-based compensation expense	482,000	17,000
Deferred income taxes	(223,000)	367,000
Loss on disposal of assets	102,000	2,000
Other		37,000
Changes in operating assets and liabilities:		

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Accounts receivable	1,334,000	316,000
Inventories	159,000	(180,000)
Prepaid expenses and other assets	65,000	305,000
Accounts payable and accrued expenses	120,000	840,000
Income taxes payable and prepaid income taxes	(288,000)	511,000
	-----	-----
Net cash provided by operating activities	3,933,000	6,386,000
	-----	-----
Cash flows from investing activities:		
Purchases of property, equipment and improvements	(945,000)	(480,000)
Capitalized software development costs	(1,353,000)	(1,987,000)
Purchases of investments	(75,175,000)	(57,325,000)
Proceeds from sales of investments	72,900,000	53,250,000
	-----	-----
Net cash used by investing activities	(4,573,000)	(6,542,000)
	-----	-----
Cash flows from financing activities:		
Tax windfall benefit from stock option exercises	25,000	
Exercise of stock options	605,000	394,000
	-----	-----
Net cash provided by financing activities	630,000	394,000
	-----	-----
Net (decrease) increase in cash and cash equivalents	(10,000)	238,000
Cash and cash equivalents at beginning of period	11,803,000	10,361,000
	-----	-----
Cash and cash equivalents at end of period	\$ 11,793,000	\$ 10,599,000
	=====	=====

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

Non-cash financing activity:

Exercise of stock options using 57,484 shares of common stock

\$ 426,000	\$
=====	=====

Noncash investing activity - During the third quarter 2005, the Company received preferred stock of InSciTek Microsystems, Inc., in satisfaction of an interest payment of \$248,000 due to the Company from InSciTek Microsystems, Inc.

The accompanying notes are an integral part of these consolidated financial statements.

PERFORMANCE TECHNOLOGIES, INCORPORATED AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (unaudited)

Note A - Basis of Presentation

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The unaudited Consolidated Financial Statements of Performance Technologies, Incorporated and Subsidiaries (the "Company") have been prepared in accordance with generally accepted accounting principles in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Accordingly, the Consolidated Financial Statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair statement have been included. The results for the interim periods are not necessarily indicative of the results to be expected for the year. The accompanying Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements of the Company as of December 31, 2005, as reported in its Annual Report on Form 10-K filed with the Securities and Exchange Commission.

### Note B - Stock-Based Compensation and Earnings Per Share

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The Company has stock options outstanding from three stock-based employee compensation plans, the Amended and Restated 1986 Incentive Stock Option Plan, the 2001 Incentive Stock Option Plan, and the 2003 Omnibus Incentive Plan.

Effective January 1, 2006, the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), "Share-Based Payment", and related interpretations, were adopted to account for stock-based compensation using the modified prospective transition method and therefore, prior period results were not restated. SFAS No. 123(R) supersedes Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees", and revises guidance of SFAS No. 123, "Accounting for Stock-Based Compensation". Among other things, SFAS No. 123(R) requires that compensation expense be recognized in the financial statements for share-based awards based on the grant-date fair value of those awards. The modified prospective transition method applies to (a) stock options granted prior to December 31, 2005 which had unrecognized compensation expense at January 1, 2006, calculated under SFAS No. 123, and (b) any new share-based awards granted subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Additionally, stock-based compensation expense includes an estimate for pre-vesting forfeitures and is recognized over the requisite service periods of the awards on a straight-line or graded vesting basis, which is generally commensurate with the vesting term. Stock-based compensation expense associated with stock option grants of \$194,000 and \$482,000 was recorded during the third quarter and the first nine months of 2006, respectively, as a result of the adoption of SFAS No. 123(R).

Prior to January 1, 2006, stock-based compensation plans were accounted for in accordance with APB No. 25 and related interpretations. Stock options may be granted to any officer or employee at not less than the fair market value at the date of grant (not less than 110% of the fair market value in the case of holders of more than 10% of the Company's common stock). Options granted under the plans generally expire between five and ten years from the date of grant and vest in periods ranging from one to six years. Prior to the adoption of SFAS No. 123(R), as required under the disclosure provisions of SFAS No. 123, as amended, pro forma net income (loss) and earnings (loss) per common share were provided for each period as if the fair value method were applied to measure stock-based compensation expense.

The table below summarizes the impact of outstanding stock options and restricted stock on the results of operations for the three and nine months ended September 30, 2006 under the provisions of SFAS No. 123(R):

Three Months Ended	Nine Months Ended
-----------------------	----------------------

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	September 30, 2006	September 30, 2006
	-----	-----
Stock based compensation expense:		
Stock options	\$ 188,000	\$ 465,000
Restricted stock	6,000	17,000
Income tax benefit	(67,000)	(165,000)
	-----	-----
Net decrease in net income	\$ 127,000	\$ 317,000
	=====	=====
Decrease in earnings per share:		
Basic	\$ .01	\$ .02
	=====	=====
Diluted	\$ .01	\$ .02
	=====	=====

The Black-Scholes-Merton option pricing model was used to estimate the fair value of share-based awards under SFAS No. 123(R) as well as for pro forma disclosures under SFAS No. 123. The Black-Scholes-Merton option pricing model incorporates various and highly subjective assumptions, including expected term and expected volatility. For valuation purposes, stock option awards were categorized into two groups, stock option grants to employees and stock option grants to members of the Board of Directors.

The expected term of options granted prior to January 1, 2006 equaled the vesting period. The expected term of options granted in 2006 was the average of the vesting term and the contractual life. The expected volatility at the grant date is estimated using historical stock prices based upon the expected term of the options granted. The risk-free interest rate assumption is determined using the rates for U.S. Treasury zero-coupon bonds with maturities similar to those of the expected term of the award being valued. Cash dividends have never been paid and are not anticipated to be paid in the foreseeable future. Therefore, the assumed expected dividend yield is zero.

SFAS No. 123(R) requires pre-vesting option forfeitures at the time of grant be estimated and periodically revised in subsequent periods if actual forfeitures differ from those estimates. Stock-based compensation expense is recorded only for those awards expected to vest using an estimated forfeiture rate based on historical pre-vesting forfeiture data. Previously, forfeitures were accounted for as they occurred under the pro forma disclosure provisions of SFAS No. 123 for periods prior to 2006.

The following table shows the detailed assumptions used to compute the fair value of stock options granted during the nine months ended September 30, 2006:

	Nine Months Ended September 30, 2006
	-----
Expected term (years)	2 to 6.5
Volatility	56% to 66%
Risk free interest rate	4.6% to 5.0%

The weighted average grant date fair value of options granted during the nine months ended September 30, 2006 was \$3.93 per option. Unrecognized stock-based compensation expense was approximately \$1,727,000 as of September 30, 2006, relating to a total of 551,000 unvested stock options under the Company's stock option plans. This stock-based compensation expense is expected to be recognized over a weighted average period of approximately four years.

The following table summarizes stock option activity for the nine months ended

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September 30, 2006:

	Number of Shares	Weighted Average Exercise Price	Exercise Price Range
Outstanding at December 31, 2005	2,118,164	\$ 9.71	\$3.40 - \$18.13
Granted	245,000	\$ 6.82	\$6.64 - \$7.50
Exercised	(223,006)	\$ 4.62	\$3.40 - \$7.25
Expired	(237,798)	\$13.22	\$3.80 - \$18.13
Outstanding at September 30, 2006	1,902,360	\$ 9.55	\$3.40 - \$18.13

The following table summarizes stock option information at September 30, 2006:

Range of exercise price	Shares	Options outstanding		Options exercisable	
		Weighted average remaining life (yrs)	Weighted average exercise price	Weighted average remaining life (yrs)	Weighted average exercise price
\$3.40 to \$5.94	405,411	2.93	\$ 4.56	321,749	1.95 \$ 4.25
\$5.95 to \$8.60	864,360	5.03	\$ 7.69	399,360	1.79 \$ 8.06
\$8.61 to \$11.40	65,500	2.42	\$10.27	65,330	2.42 \$10.27
\$11.41 to \$14.24	286,564	.30	\$13.74	284,864	.29 \$13.74
\$14.25 to \$18.13	280,525	2.55	\$18.06	280,525	2.55 \$18.06
	1,902,360	3.41	\$ 9.55	1,351,828	1.70 \$10.53

The total intrinsic value of all outstanding options and all exercisable options at September 30, 2006, whose exercise price was less than the Company's closing stock price at September 30, 2006, was \$933,000 and \$822,000 respectively. The total intrinsic value, determined as of the date of exercise, of options exercised in the first nine months of 2006 and 2005 was \$599,000 and \$444,000, respectively. Cash received from option exercises for the nine months ended September 30, 2006 and 2005, amounted to \$605,000 and \$394,000, respectively. The total fair value of options that vested during the nine months ended September 30, 2006 was \$220,000. In 2005 and 2006, shares of common stock were issued from treasury for stock option exercises.

The following table illustrates the effect on net income and earnings per common share for the three months and nine months ended September 30, 2005, as if the provisions of SFAS No. 123 were applied using the fair value method to measure stock-based compensation:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	\$ 937,000	\$ 2,190,000
Add: Restricted stock compensation expense, net of tax	4,000	11,000
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(150,000)	(2,440,000)
Pro forma net income (loss)	\$ 791,000	\$ (239,000)



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Earnings (loss) per share:		
Basic - as reported	\$ .07	\$ .17
Basic - pro forma	\$ .06	\$ (.02)
Diluted - as reported	\$ .07	\$ .17
Diluted - pro forma	\$ .06	\$ (.02)

During the nine months ended September 30, 2005, the Company granted options to purchase 204,000 shares of common stock. The assumption for vesting of the stock options granted was generally 33% per year. The following weighted-average assumptions were used for these 2005 grants: Dividend yield of 0%; expected volatility ranges of 65% to 70%, risk-free interest rate ranges of 3.3% to 3.7%, and expected life ranges of one to three years.

During the fourth quarter 2005 and the first quarter 2006, stock options to purchase 225,000 and 185,000 shares of common stock, respectively, were granted that are subject to accelerated vesting based upon the achievement of certain milestones, as defined in the option agreements. Subsequent to September 30, 2006, the option to purchase 225,000 shares of common stock terminated in connection with the resignation of the Company's former president and chief executive officer.

During 2003, 17,720 shares of restricted stock were granted at prices ranging from \$6.89 to \$12.54. During 2003, 1,740 shares of restricted stock were forfeited, without vesting. In January 2004, 10,524 shares vested and were issued. The remaining shares vest in November 2006. The value of restricted stock is charged to compensation expense over the vesting period of the grant. Unrecognized compensation expense totaled approximately \$3,000 at September 30, 2006, related to restricted stock.

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted earnings per share calculations reflect the assumed exercise and conversion of dilutive stock options and unvested restricted stock, applying the treasury stock method. Due to the net loss incurred in the third quarter 2006, there were no dilutive options. Diluted earnings per share calculations exclude the effect of approximately 1,263,000 options for the three months ended September 30, 2005, and 1,325,000 and 1,184,000 options for the nine months ended September 30, 2006 and 2005, respectively, since such options have an exercise price in excess of the average market price of the Company's common stock.

Note C - Inventories

Inventories consisted of the following:

	September 30, 2006	December 31, 2005
Purchased parts and components	\$ 2,737,000	\$ 2,884,000
Work in process	2,995,000	3,378,000
Finished goods	1,257,000	886,000
Net	\$ 6,989,000	\$ 7,148,000

The Restriction of Certain Hazardous Substances ("RoHS") Directive issued by the European Union (EU) became effective on July 1, 2006. This directive restricts the distribution of products within the EU that exceed very low maximum concentration values of certain substances, including lead. In the second

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quarter 2006, the Company recorded a charge to cost of goods sold for excess non-compliant "RoHS" inventory, which is not expected to be sold, in the amount of \$801,000.

### Note D - Investments

At September 30, 2006 and December 31, 2005, investments consisted of high grade, auction rate municipal securities which were classified as available-for-sale. As of September 30, 2006, the contractual maturity of one security held by the Company, which totaled \$1,000,000, was in 2008. The contractual maturities of all other investments held by the Company at September 30, 2006 exceeded five years.

These investments are recorded at cost, which approximates fair market value due to their variable interest rates. These investments typically reset on approximately a monthly basis, and despite the long-term nature of their stated contractual maturities, these securities historically had the ability to be quickly liquidated. All income generated from these investments was recorded as interest income.

### Note E - Warranty Obligations

Warranty obligations are incurred in connection with the sale of certain products. The warranty period is generally one year. The costs incurred to provide for these warranty obligations are estimated and recorded as an accrued liability at the time of sale. Future warranty costs are estimated based on product-based historical performance rates and related costs to repair. Changes in accrued warranty obligations for the nine months ended September 30, 2006 and 2005 were as follows:

	2006	2005
	-----	-----
Accrued warranty obligations, January 1,	\$ 310,000	\$ 288,000
Actual warranty experience	(136,000)	(95,000)
Warranty provisions	135,000	117,000
	-----	-----
Accrued warranty obligations, September 30,	\$ 309,000	\$ 310,000
	=====	=====

### Note F - Stock Repurchase Program

On July 11, 2005, a plan to repurchase shares of common stock for an aggregate amount not to exceed \$10,000,000 was authorized by the Board of Directors. In July 2006, this program was extended by the Board of Directors through July 13, 2007. Under this program, shares of common stock may be repurchased through open market or private transactions, including block purchases. Repurchased shares can be used for stock option plans, potential acquisition initiatives and general corporate purposes. Through September 30, 2006, there have been no repurchases of shares under the original or the extended program.

### Note G - Income Taxes

The Company's effective income tax rate is a combination of federal, state and foreign tax rates and is generally lower than statutory rates because it includes benefits derived from international operations, research activities, tax exempt interest and foreign sales. For the third quarter 2006, the income tax benefit amounted to \$408,000, which included an income tax benefit of \$68,000 and discrete income tax benefit items of \$340,000. The discrete income tax benefit items realized during the third quarter 2006 primarily related to the release of a reserve for income tax uncertainties of \$383,000, partially offset by the recording of an income tax provision uncertainty adjustment of \$47,000. The tax uncertainties were released based upon the lapsing of the statute of limitations related to these uncertainties.

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For the nine months ended September 30, 2006, the income tax benefit amounted to \$346,000, which included an income tax provision of \$54,000 and discrete income tax benefit items totaling \$400,000. The discrete income tax benefit items included a previously unused tax credit of \$60,000 and the release of a reserve for income tax uncertainties of \$383,000, partially offset by the recording of an income tax provision uncertainty adjustment of \$47,000. The effective tax rate was 29% for both the third quarter and the first nine months of 2005.

### Note H - Restructuring Costs

Restructuring charges amounted to \$792,000 and \$53,000 in the third quarter 2006 and 2005, respectively, and \$1,786,000 and \$249,000 for the nine months ended September 30, 2006 and 2005, respectively.

During the third quarter 2006, the Company terminated seven employees and recorded \$139,000 of severance costs related to these terminations. In addition, during the third quarter 2006, the Company relocated its San Luis Obispo engineering center to a less expensive facility which resulted in lease termination costs amounting to \$653,000. Restructuring charges in the first and second quarter of 2006 primarily related to severance and facility expenses incurred for the closing of the Company's Norwood, Massachusetts engineering center. Substantially all actions under these programs were completed as of September 30, 2006, although payments for the severance reserve will occur in the fourth quarter 2006 and payments for certain lease obligations will continue through 2008.

A summary of the activity with respect to the 2006 restructuring charges is as follows:

	Number of employees	Severance Reserve	Lease commitments and other	Total
Balance at January 1, 2006				
2006 restructuring charges	29	\$970,000	\$816,000	\$1,786,000
2006 utilization	(29)	(831,000)	(230,000)	(1,061,000)
Balance at September 30, 2006		\$139,000	\$586,000	\$ 725,000

Restructuring charges in 2005 related primarily to severance payments associated with the Company's efforts to centralize its operations.

### Note I - Lease Commitments

During the second quarter 2006, the Company entered into a lease for a facility in Kanata, Ontario, Canada. The lease term extends from August 1, 2006 to October 31, 2011. The Company's Ottawa operation relocated to this facility during the third quarter 2006.

In July 2006, the Company entered into a two-year lease for a facility in the San Luis Obispo area which commenced on September 1, 2006. During the third quarter 2006, the Company's San Luis Obispo engineering center relocated to this facility.

For both lease agreements, the Company is required to pay the pro rata share of the real property taxes and assessments, expenses and other charges associated with these facilities.

Future combined minimum payments under these two new leases as of September 30, 2006, are as follows:

Amount

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2006	\$	55,000
2007		244,000
2008		224,000
2009		169,000
2010		181,000
Thereafter		151,000
		-----
Total	\$	1,024,000
		=====

Note J - Recent Accounting Pronouncements

On January 1, 2006, the Company adopted SFAS No. 151, "Inventory Costs - An Amendment of ARB No. 43, Chapter 4." SFAS No. 151 states that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges. This adoption did not have a material impact on the Company's consolidated results of operations and financial condition.

In July 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109, "Accounting for Income Taxes." This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48. The Company will adopt this Interpretation in the first quarter of 2007.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements. SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. The Company will adopt this SAB in the first quarter of 2007. The Company is currently assessing the potential impact that the adoption of SAB No. 108 will have on its financial statements; the impact is not expected to be material.

Note K - Subsequent Event

In October 2006, the Company and Michael P. Skarzynski, the Company's former president and chief executive officer, agreed to a consulting agreement in connection with Mr. Skarzynski's resignation. Under the terms of the agreement, Mr. Skarzynski will assist the Company with the transition of his former duties through March 31, 2007. In exchange for the transition services, the Company will make initial payment of \$50,000 to Mr. Skarzynski on or by November 1, 2006; an additional payment of \$40,000 on December 31, 2006; and a final payment of \$10,000 on March 31, 2007.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Matters discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-Q include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those discussed in the forward-looking statements.

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### Critical Accounting Estimates and Assumptions

In preparing the financial statements in accordance with GAAP, estimates and assumptions are required to be made that have an impact on the assets, liabilities, revenue and expense amounts reported. These estimates can also affect supplemental information disclosures, including information about contingencies, risk and financial condition. Estimates are generally not made until preliminary results for a financial quarter are known and analyzed. It is believed that given the current facts and circumstances, these estimates and assumptions are reasonable, adhere to GAAP, and are consistently applied. Inherent in the nature of an estimate or assumption is the fact that actual results may differ from estimates, and estimates may vary as new facts and circumstances arise. The critical accounting policies, judgments and estimates that we believe have the most significant effect on our financial statements are set forth below:

- o Revenue Recognition
- o Software Development Costs
- o Valuation of Inventories
- o Income Taxes
- o Product Warranty
- o Carrying Value of Goodwill
- o Stock-Based Compensation
- o Restructuring Costs

Revenue Recognition: Revenue is recognized from product sales in accordance with the SEC Staff Accounting Bulletin No. 104, "Revenue Recognition." Product sales represent the majority of our revenue and include both hardware products and hardware products with embedded software. Revenue is recognized from these product sales when persuasive evidence of an arrangement exists, delivery has occurred or services have been provided, the sale price is fixed or determinable, and collectability is reasonably assured. Additionally, products are sold on terms which transfer title and risk of loss at a specified location, typically the shipping point. Accordingly, revenue recognition from product sales occurs when all factors are met, including transfer of title and risk of loss, which typically occurs upon shipment. If these conditions are not met, revenue recognition is deferred until such time as these conditions have been satisfied.

Revenue earned from arrangements for software is accounted for under the provisions of Statement of Position 97-2, "Software Revenue Recognition" and EITF Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." Revenue from software requiring significant production, modification, or customization is recognized using the percentage of completion method of accounting. Any anticipated losses on contracts are charged to operations as soon as such losses are determined. If all conditions of revenue recognition are not met, revenue recognition is deferred and revenue will be recognized when all obligations under the arrangement are fulfilled. Revenue from software maintenance contracts is recognized ratably over the contractual period.

Revenue from consulting and other services is recognized at the time the services are rendered. Certain products are sold through distributors who are granted limited rights of return. Potential returns are accounted for at the time of sale.

The accounting estimate related to revenue recognition is considered a "critical accounting estimate" because terms of sale can vary, and judgment is exercised in determining whether to defer revenue recognition. Such judgments may materially affect net sales for any period. Judgment is exercised within the parameters of GAAP in determining when contractual obligations are met, title and risk of loss are transferred, sales price is fixed or determinable and collectability is reasonably assured.

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**Software Development Costs:** All software development costs incurred in establishing the technological feasibility of computer software products to be sold are research and development costs. Software development costs incurred subsequent to the establishment of technological feasibility of a computer software product to be sold and prior to general release of that product are capitalized. Amounts capitalized are amortized commencing after general release of that product over the estimated remaining economic life of that product, generally three years, or using the ratio of current revenues to current and anticipated revenues from such product, whichever provides greater amortization. If the technological feasibility for a particular project is judged not to have been met or recoverability of amounts capitalized is in doubt, project costs are expensed as research and development or charged to cost of goods sold, as applicable. The accounting estimate related to software development costs is considered a "critical accounting estimate" because judgment is exercised in determining whether project costs are expensed as research and development or capitalized as an asset. Such judgments may materially affect expense amounts for any period. Judgment is exercised within the parameters of GAAP in determining when technological feasibility has been met and recoverability of software development costs is reasonably assured.

**Valuation of Inventories:** Inventories are stated at the lower of cost or market, using the first-in, first-out method. Inventory includes purchased parts and components, work in process and finished goods. Provisions for excess, obsolete or slow moving inventory are recorded after periodic evaluation of historical sales, current economic trends, forecasted sales, estimated product lifecycles and estimated inventory levels. Purchasing practices, electronic component obsolescence, accuracy of sales and production forecasts, introduction of new products, product lifecycles, product support and foreign regulations governing hazardous materials are the factors that contribute to inventory valuation risks. Exposure to inventory valuation risks is managed by maintaining safety stocks, minimum purchase lots, managing product end-of-life issues brought on by aging components or new product introductions, and by utilizing certain inventory minimization strategies such as vendor-managed inventories. The accounting estimate related to valuation of inventories is considered a "critical accounting estimate" because it is susceptible to changes from period-to-period due to the requirement for management to make estimates relative to each of the underlying factors, ranging from purchasing, to sales, to production, to after-sale support. If actual demand, market conditions or product lifecycles differ from estimates, inventory adjustments to lower market values would result in a reduction to the carrying value of inventory, an increase in inventory write-offs and a decrease to gross margins.

**Income Taxes:** Income taxes are accounted for using the asset and liability approach, which requires recognition of deferred tax liabilities and assets for the expected future tax consequences of the temporary differences between the carrying amounts and the tax basis of such assets and liabilities. A valuation allowance is recorded to reduce deferred tax assets to the amount that is more likely than not to be realized. The accounting estimate related to income taxes is considered a "critical accounting estimate" because judgment is exercised in estimating future taxable income, including prudent and feasible tax planning strategies, and in assessing the need for any valuation allowance. If it should be determined that all or part of a net deferred tax asset is not able to be realized in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made. Likewise, in the event that it should be determined that all or part of a deferred tax asset in the future is in excess of the net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made.

**Product Warranty:** Warranty obligations are incurred in connection with the sale of certain products. The warranty period for these products is generally one year. The costs incurred to provide for these warranty obligations are estimated

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and recorded as an accrued liability at the time of sale. Future warranty costs are estimated based on historical performance rates and related costs to repair given products. The accounting estimate related to product warranty is considered a "critical accounting estimate" because judgment is exercised in determining future estimated warranty costs. Should actual performance rates or repair costs differ from estimates, revisions to the estimated warranty liability would be required.

**Carrying Value of Goodwill:** Tests for impairments of goodwill are conducted annually, at year end, or more frequently if circumstances indicate that the asset might be impaired. The accounting estimate related to impairment of goodwill is considered a "critical accounting estimate" because these impairment tests include estimates of future cash flows that are dependent upon subjective assumptions regarding future operating results including growth rates, discount rates, capital requirements and other factors that impact the estimated fair value. An impairment loss is recognized to the extent that the goodwill's carrying amount exceeds its fair value.

**Stock-Based Compensation:** Stock options are granted to purchase our common stock. Under the provisions of SFAS No. 123(R), stock compensation expense is recorded based upon the fair value of the stock option at the date of grant. The accounting estimate related to stock-based compensation is considered a "critical accounting estimate" because estimates are made in calculating compensation expense including: expected option lives, forfeiture rates and expected volatility. Expected option lives are estimated using vesting terms and contractual lives. Expected forfeiture rates and volatility are calculated using historical information. Actual option lives and forfeiture rates may be different from estimates and may result in potential future adjustments which would impact the amount of stock-based compensation expense recorded in a particular period.

**Restructuring Costs:** Restructuring costs consist of employee-related severance costs, lease termination costs and other facility-related closing expenses. Employee-related severance benefits are recorded either at the time an employee is severed or is estimated and recorded pro-rata over the period of each planned restructuring activity. Lease termination costs are calculated using remaining lease obligation amounts and estimates for sublease receipts. The accounting estimate related to restructuring costs is considered a "critical accounting estimate" because estimates are made in calculating the amount of employee-related severance benefits that will ultimately be paid and the amount of sublease receipts that will ultimately be received in future periods. Actual amounts paid for employee-related severance benefits can vary from these estimates depending upon the number of employees actually receiving severance payments.

### Overview

The following contains forward-looking statements within the meaning of the Securities Act of 1933 and Securities Exchange Act of 1934 and these forward-looking statements are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

The Company is a leading developer of platforms, blades and software solutions for the communications market. It targets three vertical markets: telecommunications, defense and homeland security, and commercial. Of the three vertical markets served, telecommunications is the largest and represents approximately 80% of the Company's business. An approximate breakdown of telecommunications applications utilizing the Company's products is as follows: Voice-over-IP (VoIP) represents 40%, wireless infrastructure represents 40%, and the remaining 20% is spread across IP multimedia and other applications.

The Company's products are marketed through a direct worldwide sales force under

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a variety of brand names including IPnexus(TM), SEGway(TM), NexusWare(TM) and Advanced Managed Platforms(TM). These products are based on open standards and are sold as fully-integrated, purpose-built, application ready platforms, or as individual blade components for the embedded communications marketplace. A key differentiation of the Company's products is the internally developed software available with each product. When sold as platforms, known as our Advanced Managed Platform products, our customers can quickly move to the enhanced value steps of their products while realizing distinct cost advantages, increased overall system reliability and performance, and improved time-to-market. Since its introduction in 2003, our Advanced Managed Platform product line has realized more than 34 new design wins. If successfully implemented by our customers, each design win is expected to generate greater than \$.5 million of annualized revenue when reaching production volumes. In addition, we also realized more than 36 new design wins for blade solutions in this same time period. Design wins are subject to risks and uncertainties and, therefore, not all design wins are expected to result in production orders.

A company-wide transformation began in early 2006, which management believes will establish the foundation upon which the Company can reach its growth goals. This transformation is balancing the Company's traditional engineering and technology focus with a stronger emphasis on sales and marketing. Since the beginning of the year, we have hired ten senior salespeople, including sales executives for global sales, signaling sales and European sales, to expand, bolster and partially replace our direct, world-wide sales organization.

We recognize the need to balance investments in sales and marketing with projected revenue growth and expense reductions in other areas of the business. Since the beginning of the year, we have instituted a number of expense reduction initiatives, including closing our Norwood engineering facility, relocating our San Luis Obispo engineering center to a less expensive facility and implementing reductions-in-force. The relocation of the San Luis Obispo engineering center and a 3% company-wide reduction-in-force were completed in the third quarter 2006. Restructuring costs primarily associated with these activities amounted to \$.8 million and \$1.8 million in the third quarter and for the nine months ended September 30, 2006, respectively.

The telecommunications market served by the Company depends upon carrier spending to upgrade network infrastructure to next-generation equipment. During the third quarter 2006, investments by U.S. wireless carriers in third generation mobile networks continued to be selective and this trend adversely impacted the Company's revenue. The Company's largest customer during the first nine months of 2006 sells directly into the U.S. wireless market, and third quarter shipments to this customer amounted to \$.8 million, compared to \$2.2 million in the preceding quarter and \$3.0 million in the comparable quarter in 2005. The third quarter revenue shortfall was also attributable to several signaling customers in North America and Europe that delayed product deployments beyond the third quarter. Management believes these signaling deployment delays are customer specific, rather than due to any lack of demand for the Company's signaling products.

On October 13, 2006, Michael P. Skarzynski resigned as president, chief executive officer and as a member of the Board of Directors, for personal reasons. Mr. Skarzynski's resignation was accepted by the Company and the Company's current chairman, John M. Slusser, was appointed to serve as interim president and chief executive officer until a successor can be found. During the transition period, Mr. Slusser will continue in his role as chairman. The Board of Directors has established an Executive Transition Committee, which will oversee the process through which a new chief executive officer will be selected. Subsequent to September 30, 2006, the Company entered into a short-term consulting arrangement with Mr. Skarzynski to assist with the transition of his former responsibilities to Mr. Slusser.



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### Strategy

The Company has a history of successfully adapting its products and services to a constantly changing technology-driven marketplace. This adaptation has been demonstrated through the course of several business cycles that have occurred since the Company's founding in 1981.

A new product strategy was adopted in 2003. This strategy repositioned the Company to deliver fully managed, system-level platform products to the embedded communications marketplace and resulted in the Company's ability to address over 60% of the served available market. Today, our line of platform products specifically addresses equipment manufacturers' requirements for an increased level of system integration and services from suppliers, thus allowing them to focus on their value-added stages of product development, which in most cases is application software. The Company's strategy also enables its customers to replace proprietary or legacy platforms with the latest generation of platform products.

The Company's goal is to drive sustained and profitable revenue growth. A company-wide transformation began in early 2006, which management believes will establish the foundation upon which the Company can reach its growth goals. This transformation is balancing the Company's traditional engineering and technology focus with a stronger emphasis on sales and marketing. Management believes that its current products and product pipeline can support a substantially higher revenue base. With the Company's new sales organization now in place, management expects to replicate key customer sales successes and aggressively pursue new sales opportunities as the basis for the Company's future earnings and revenue growth.

There are identifiable risks associated with carrying out the Company's strategy in the current uncertain economic climate. Many of the Company's end markets are forecasted to show only modest growth in the near term. In order to realize growth in this environment, the Company will have to gain market share from competitors, many of which are larger, more established companies with greater resources than the Company's. Management believes that its strategy to increase emphasis on sales and marketing, while continuing to invest in new product development, will enable the Company to successfully compete in this economic environment.

### Financial Information

#### Revenue:

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Revenue in the third quarter 2006 amounted to \$10.8 million, compared to \$12.3 million in the corresponding quarter a year earlier. Revenue for the nine months ended September 30, 2006 amounted to \$36.0 million, compared to \$36.3 million during the corresponding period in 2005.

#### Earnings and Loss:

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Net loss for the third quarter 2006 totaled \$.4 million, or \$.03 per basic share, based on 13.3 million shares outstanding and included:

- o Restructuring charges of \$.8 million, or \$.06 per basic share, primarily related to the relocation of our San Luis Obispo engineering center and severance costs related to a Company-wide reduction in force;
- o Stock compensation expense of \$.2 million, or \$.02 per basic share; and
- o Discrete income tax benefits amounting to \$.3 million, or \$.03 per basic share.

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Net income for the third quarter 2005 amounted to \$.9 million, or \$.07 per diluted share and included restructuring charges of \$.1 million, or \$.00 per diluted share, based on 13.1 million shares outstanding.

Net income for the nine months ended September 30, 2006 amounted to \$.2 million, or \$.02 per diluted share, based on 13.3 million shares outstanding and included:

- o A charge for non-compliant RoHS inventory of \$.8 million, or \$.05 per diluted share;
- o Restructuring charges of \$1.8 million, or \$.10 per diluted share, related to severance and facilities costs associated with the closing of our Norwood engineering center, the relocation of our San Luis Obispo engineering center and severance costs related to Company-wide reductions in force;
- o Stock compensation expense of \$.5 million, or \$.03 per diluted share; and
- o Discrete income tax benefits amounting to \$.4 million, or \$.03 per diluted share.

Net income for the nine months ended September 30, 2005 amounted to \$2.2 million, or \$.17 per diluted share, including restructuring charges related to centralization efforts amounting to \$.2 million, or \$.01 per diluted share, based on 13.1 million shares outstanding.

### Liquidity:

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Cash, cash equivalents and investments amounted to \$35.2 million and \$33.0 million at September 30, 2006 and December 31, 2005, respectively. We had no long-term debt at either date.

### Centralization and Relocation of Functions:

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In January 2006, we announced a plan to close our engineering center in Norwood, Massachusetts, and transfer product development and customer support functions for the voice technology products to our other engineering centers. This program was completed in May 2006.

During the third quarter 2006, our engineering center in San Luis Obispo, California was relocated to a new facility in the same city and our signaling engineering organization in Ottawa, Ontario, Canada was relocated to a new facility in Kanata, Ontario, outside of Ottawa.

### Key Performance Indicators:

The Company works closely with customers to incorporate its platforms, blades and software solutions into their product designs. Such "design wins" have been a useful metric for management to judge the Company's product acceptance in its marketplace. Design wins, if successfully implemented by our customers, reach production volumes at varying rates, generally beginning twelve to eighteen months after the design win occurs. A variety of risks such as schedule delays, cancellations, changes in customer markets and economic conditions can adversely affect a design win before production is reached or during deployment. Beginning in 2006, our sales organization is targeting higher revenue major accounts which may lower the total number of design wins reported in the future, although management expects such design wins will generate higher value design wins.

During the third quarter 2006, we realized two design wins for our Advanced Managed Platform (with multiple products) (1), and individual communications products (1). During the third quarter 2005, the Company realized six design wins comprised of Advanced Managed Platform (with multiple products) (1), and individual communications products (5). Each design win is expected to generate

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at least \$.5 million of annualized revenue when reaching production volumes. Not all design wins are expected to result in production orders.

We believe that another key indicator for our business is the volume of orders received from our customers. During weak or uncertain economic periods, visibility of customer orders is limited, which frequently causes delays in the placement of orders with the Company. These factors often result in a substantial portion of the Company's revenue being derived from orders placed within a quarter and shipped in the final month of the same quarter. Forward-looking visibility of customer orders continues to be very limited. Shipments to customers in the third quarter 2006 amounted to \$10.8 million, compared to \$12.3 million in the third quarter 2005. The Company's largest customer during the first nine months of 2006 sells directly into the U.S. wireless market and third quarter shipments to this customer amounted to \$.8 million, compared to \$3.0 million in the comparable quarter in 2005. In addition, several signaling customers in North America and Europe delayed anticipated product deployments beyond the third quarter 2006. Management believes the signaling deployment delays are customer specific, rather than due to any lack of demand for the Company's signaling products.

More in-depth discussions of our strategy and financial performance can be found in our Annual Report on Form 10-K and other filings with the Securities and Exchange Commission.

Three and Nine Months Ended September 30, 2006, compared with  
the Three and Nine Months Ended September 30, 2005

The following table presents the percentage of sales represented by each item in our consolidated statements of income for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	51.9	49.9	49.1	51.0
Non RoHS inventory charge			2.2	
Gross profit	48.1	50.1	48.7	49.0
Operating expenses:				
Selling and marketing	14.6	10.9	12.2	11.5
Research and development	23.7	21.6	23.2	20.8
General and administrative	13.4	9.2	11.6	10.1
Restructuring charges	7.3	0.4	5.0	0.7
Total operating expenses	59.0	42.1	52.0	43.1
(Loss) income from operations	(10.9)	8.0	(3.3)	5.9
Other income, net	3.6	2.7	3.0	2.6
(Loss) income before income taxes	(7.3)	10.7	(0.3)	8.5
Income tax (benefit) provision	(3.8)	3.1	(1.0)	2.5
Net (loss) income	(3.5)%	7.6%	0.7%	6.0%

Sales. Total revenue for the third quarter 2006 amounted to \$10.8 million, compared to \$12.3 million for the corresponding quarter in 2005. Revenue for the nine months ended September 30, 2006 totaled \$36.0 million, compared to \$36.3

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million for the comparable period in 2005.

In the third quarter 2006, one customer represented 21% of sales and our four largest customers represented 41% of sales. In the third quarter 2005, two customers represented 25% and 14% of sales, and our four largest customers represented 48% of sales. For the nine months ended September 30, 2006, two customers represented 16% and 12% of sales, and our four largest customers represented 39% of sales. For the nine months ended September 30, 2005, two customers represented 21% and 12% of sales, and our four largest customers represented 44% of sales.

Sales to customers outside of the United States represented 60% and 46% of our sales during the third quarter 2006 and 2005, respectively. During this comparative period, although overall Company sales decreased, sales to customers outside the United States increased slightly, resulting in the percentage increase described above. This increase in sales to customers outside the United States was attributable to increased sales to the Company's largest integrated platform customer. Sales to customers based in the United Kingdom represented 25% and 15% of revenue in the third quarter 2006 and 2005, respectively.

For the nine months ended September 30, 2006 and 2005, sales to customers outside of the United States represented 48% and 42% of sales, respectively. Sales to customers based in the United Kingdom represented 15% and 13% of revenue for the nine months ended September 30, 2006 and 2005, respectively.

Beginning in 2006, our products are grouped into three distinct categories in one market segment: Communications (network access, signaling and voice) products, Computing products and Switching products. Revenue from each product category is expressed as a percentage of sales for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Communications	45%	43%	49%	47%
Computing	34%	25%	26%	25%
Switching	21%	31%	25%	27%
Other		1%		1%
Total	100%	100%	100%	100%
	=====	=====	=====	=====

### Communications products:

Communications products are comprised of network access, SEGway signaling and Voice Technology products. Network access products provide a connection between a variety of voice, data and signaling networks and embedded systems platforms that are used to control the network and/or process information being transported over networks. This family includes a complete line of communications protocols. Many of our signaling products provide a signaling bridge between traditional telephone networks and the growing IP packet-switched network, and enable the transport of signaling messages over IP networks. Voice Technology products enable voice, data and fax processing for communications applications.

Revenue from Communications products amounted to \$4.9 million and \$5.3 million in the third quarter of 2006 and 2005, respectively. This decrease of \$.4 million, or 8%, was the result of decreased demand from a variety of our customers across this product category.

Revenue from Communications products amounted to \$17.5 million and \$17.0 million in the nine months ended September 30, 2006 and 2005, respectively. This

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increase in business of \$.5 million, or 3%, reflects a combination of factors including one major customer in 2005 that, due to market conditions, unexpectedly decreased product requirements after the second quarter 2005, which was offset by a greater demand from a variety of customers across this product category.

### Computing products:

Computing products include integrated platform solutions, a range of single board computers, a variety of embedded system chassis and associated chassis management products.

Computing products revenue amounted to \$3.7 million and \$3.1 million in the third quarter 2006 and 2005, respectively. The increase in revenue of \$.6 million, or 19%, for these comparative periods is primarily a result of increased sales to the Company's largest integrated platform customer.

For the nine months ended September 30, 2006 and 2005, Computing products revenue totaled \$9.5 million, compared to \$9.2 million, respectively. The increase in revenue of \$.3 million, or 3%, was primarily attributable to fluctuations in sales to various customers during the comparative periods.

### Switching products:

Our Ethernet switch components operate as the "nexus" of the IP packet switching functionality of the Advanced Managed Platforms.

Revenue from Switching products amounted to \$2.2 million and \$3.8 million in the third quarter 2006, and 2005, respectively. This decrease of \$1.6 million, or 42%, is primarily the result of decreased shipments to one customer amounting to \$2.2 million who purchased less due to their decreased customer demand, partially offset by increased sales to several other switch customers.

Switch revenue totaled \$9.0 million and \$9.6 million for the nine months ended September 30, 2006 and 2005, respectively. This decrease of \$.6 million, or 6%, is a result of a combination of decreased sales to one customer of \$2.0 million who purchased less due to their decreased customer demand, partially offset by increased sales to several other customers in this product category.

Gross profit. Gross profit consists of sales, less cost of goods sold including material costs, manufacturing expenses, depreciation, amortization of software development costs, and expenses associated with engineering contracts and the technical support function. Gross margin was 48.1% and 50.1% of sales for the third quarter 2006 and 2005, respectively. The decrease in gross margin primarily resulted from a change in sales mix from higher margin products (e.g., Switching) to lower margin products (i.e., Computing). Gross margin for the quarter was also negatively impacted by lower production volumes. Offsetting these decreases were benefits resulting from our centralization efforts that took place in 2005. Included in cost of goods sold is the amortization of software development costs which totaled \$.4 million and \$.3 million in the third quarter 2006 and 2005, respectively.

Gross margin was 48.7% and 49.0% of sales for the first nine months of 2006 and 2005, respectively. The Restriction of Certain Hazardous Substances ("RoHS") Directive issued by the European Union (EU) became effective on July 1, 2006. Gross margin for the first nine months of 2006 was impacted by a charge recorded in the second quarter to cost of goods sold for excess non-compliant RoHS inventory in the amount of \$.8 million, or 2.2% of revenue. Excluding this charge, the increase in gross margin was attributable to benefits realized from the Company's centralization efforts. Also included in cost of goods sold is the amortization of software development costs which totaled \$1.2 million for both the nine months ended September 30, 2006 and 2005.

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Total Operating Expenses. Total operating expenses in the third quarter 2006 amounted to \$6.4 million, compared to \$5.2 million for the corresponding period in 2005. Total operating expenses in the third quarter 2006 included restructuring charges amounting to \$.8 million and stock compensation expense related to the adoption of SFAS 123(R) amounting to \$.2 million. Total operating expenses in the third quarter 2005 included restructuring charges amounting to \$.1 million.

Total operating expenses for the nine months ended September 30, 2006 amounted to \$18.7 million, compared to \$15.6 million for the corresponding period in 2005. Total operating expenses for the nine months ended September 30, 2006 included restructuring charges amounting to \$1.8 million and stock compensation expense amounting to \$.5 million. Total operating expenses for the nine months ended September 30, 2005 included restructuring charges amounting to \$.2 million.

Selling and marketing expenses were \$1.6 million and \$1.3 million for the third quarter 2006 and 2005, respectively, and \$4.4 million and \$4.2 million for the first nine months of 2006 and 2005, respectively. The increases in expenses in both comparative periods are primarily related to additional sales personnel hired in 2006 as a key component of the Company's transformation program.

Research and development expenses were \$2.6 million and \$2.7 million in the third quarter 2006 and 2005, respectively. We capitalize certain software development costs, which reduces the amount charged to research and development expenses. Amounts capitalized were \$.4 million and \$.7 million during the third quarter 2006 and 2005, respectively. The decrease in gross research and development expenditures for the comparable periods is primarily the result of the closing of the Norwood engineering center during the second quarter 2006.

Research and development expenses totaled \$8.3 million and \$7.6 million for the nine months ended September 30, 2006 and 2005, respectively. Amounts capitalized were \$1.4 million and \$2.0 million for the nine month periods in 2006 and 2005, respectively. Gross expenditures for the comparative periods were generally comparable.

General and administrative expenses were \$1.5 million and \$1.1 million in the third quarter 2006 and 2005, respectively. General and administrative expenses totaled \$4.2 million and \$3.7 million for the nine months ended September 30, 2006 and 2005, respectively. The increase in expenses for both comparative periods is primarily related to higher personnel costs, higher corporate governance costs and stock based compensation expense in 2006.

Restructuring charges amounted to \$.8 million and \$.05 million in the third quarter 2006 and 2005, respectively, and \$1.8 million and \$.2 million for the nine months ended September 30, 2006 and 2005, respectively.

During the third quarter 2006, the Company terminated seven employees and recorded \$.1 million of severance costs related to these terminations. In addition, during the third quarter 2006, the Company relocated its San Luis Obispo engineering center to a less expensive facility which resulted in lease termination costs amounting to \$.7 million. Restructuring charges in first and second quarter of 2006 primarily related to severance and facility expenses incurred for the closing of the Company's Norwood, Massachusetts engineering center. Substantially all actions under these programs were completed as of September 30, 2006, although payments for the severance reserve will occur in the fourth quarter 2006 and payments for certain lease obligations will continue through 2008.

A summary of the activity with respect to the 2006 restructuring charges is as follows:

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	Number of employees	Severance Reserve	Lease commitments and other	Total
Balance at January 1, 2006				
2006 restructuring charges	29	\$970,000	\$816,000	\$1,786,000
2006 utilization	(29)	(831,000)	(230,000)	(1,061,000)
Balance at September 30, 2006		\$139,000	\$586,000	\$ 725,000

Restructuring charges in 2005 related primarily to severance payments associated with the Company's efforts to centralize its operations.

The Company is not expecting to incur any restructuring charges in the fourth quarter 2006.

Other Income, net. Other income consists primarily of interest income. The Company's funds are primarily invested in high quality auction rate municipal securities. An increase in the funds available for investment as well as higher interest rates in 2006 resulted in an increase in interest income. Interest income in 2005 also included interest income from a note receivable from an unconsolidated company.

Income taxes. The effective income tax rate is a combination of federal, state and foreign tax rates and is generally lower than statutory rates because it includes benefits derived from our international operations, research activities, tax exempt interest and foreign sales. For the third quarter 2006, the income tax benefit amounted to \$.4 million, which included an income tax benefit of \$.1 million and discrete income tax benefit items of \$.3 million. The discrete income tax benefit items realized during the third quarter 2006 primarily related to the release of a reserve for income tax uncertainties of \$.4 million, partially offset by the recording of an income tax provision uncertainty adjustment of \$.05 million. The tax uncertainties were released based upon the lapsing of the statute of limitations related to these uncertainties.

For the nine months ended September 30, 2006, the income tax benefit amounted to \$.3 million, which included an income tax provision of \$.1 million and discrete income tax benefit items totaling \$.4 million. The discrete income tax benefit items included a previously unused tax credit of \$.1 million and the release of a reserve for income tax uncertainties of \$.4 million, partially offset by the recording of an income tax provision uncertainty adjustment of \$.05 million. The effective tax rate was 29% for both the third quarter and the first nine months of 2005.

#### LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity are cash, cash equivalents and investments, which together totaled \$35.2 million at September 30, 2006. The Company had working capital of \$48.1 million and \$46.8 million at September 30, 2006 and December 31, 2005, respectively.

Cash provided by operating activities amounted to \$3.9 million for the nine months ended September 30, 2006. This amount included net income of \$.2 million, a depreciation and amortization charge of \$1.7 million and stock-based compensation expense of \$.5 million. Cash provided by operations due to changes in operating assets and liabilities included an increase in cash associated with a decrease in accounts receivable of \$1.3 million. The decrease in accounts receivable is primarily related to lower sales in the final month of the third quarter 2006.

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On July 1, 2006, the RoHS Directive issued by the EU became effective. This directive restricts the distribution of products within the EU that exceed very low maximum concentration values of certain substances, including lead. During the second quarter 2006, a charge was recorded in the amount of \$.8 million for non-compliant RoHS inventory not expected to be sold in the future.

Cash used by investing activities during the first nine months of 2006 totaled \$4.6 million. This utilization was primarily the result of capital asset purchases of \$.9 million, the capitalization of software development costs amounting to \$1.4 million and a net increase in investments of \$2.3 million.

Cash provided by financing activities for the first nine months of 2006 amounted to \$.6 million, primarily resulting from the exercise of stock options. On July 11, 2005, our Board of Directors authorized the Company to repurchase shares of our common stock for an aggregate amount not to exceed \$10.0 million. In July 2006, this program was extended to July 13, 2007. Under this program, shares of our common stock may be repurchased through open market or private transactions, including block purchases. Repurchased shares can be used for our stock option plans, potential acquisition initiatives and general corporate purposes. Through September 30, 2006, there have been no repurchases of shares under the original or the extended program.

### Off-Balance Sheet Arrangements:

No off-balance sheet arrangements were entered into during the first nine months of 2006.

### Contractual Obligations:

During the second quarter 2006, a lease agreement was entered into for a new facility in Kanata, Ontario, Canada. The term of this lease extends from August 1, 2006 to October 31, 2011. During the third quarter 2006, our Ottawa operation relocated to this facility.

In July 2006, the Company entered into a two-year lease for a facility in the San Luis Obispo area which commenced on September 1, 2006. During the third quarter 2006, our San Luis Obispo engineering center relocated to this facility.

For both lease agreements, the Company is required to pay the pro rata share of the real property taxes and assessments, expenses and other charges associated with these facilities.

As of September 30, 2006, combined future minimum payments under these two new leases are as follows:

	Amount
2006	\$ 55,000
2007	244,000
2008	224,000
2009	169,000
2010	181,000
Thereafter	151,000
Total	\$ 1,024,000

No other significant contractual obligations were entered into during the first nine months of 2006.

In October 2006, the Company and Michael P. Skarzynski, the Company's former president and chief executive officer, agreed to a consulting agreement in connection with Mr. Skarzynski's resignation. Under the terms of the agreement,



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Mr. Skarzynski will assist the Company with the transition of his former duties through March 31, 2007. In exchange for the transition services, the Company will make an initial payment of \$50,000 to Mr. Skarzynski on or by November 1, 2006; an additional payment of \$40,000 on December 31, 2006; and a final payment of \$10,000 on March 31, 2007.

### Current Position:

Assuming there is no significant change in our business, we believe that the Company's current cash, cash equivalents and investments, together with cash generated from operations should be sufficient to meet our anticipated cash requirements, including working capital and capital expenditure requirements, for at least the next twelve months. However, we are continuing to evaluate strategic acquisitions to further accelerate our growth and market penetration efforts. These strategic acquisition efforts could have an impact on our working capital, liquidity or capital resources and we may raise additional capital to facilitate these efforts.

### RECENT ACCOUNTING PRONOUNCEMENTS

On January 1, 2006, the Company adopted SFAS No. 151, "Inventory Costs - An Amendment of ARB No. 43, Chapter 4." SFAS No. 151 states that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges. This adoption did not have a material impact on the Company's consolidated results of operations and financial condition.

In July 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). FIN 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109, "Accounting for Income Taxes." This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48. The Company will adopt this Interpretation in the first quarter of 2007.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements. SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. The Company will adopt this SAB in the first quarter of 2007. The Company is currently assessing the potential impact that the adoption of SAB No. 108 will have on its financial statements; the impact is not expected to be material.

### FORWARD-LOOKING STATEMENTS AND RISK FACTORS

This quarterly report on Form 10-Q contains forward-looking statements, which reflect our current views with respect to future events and financial performance, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and is subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are subject to certain risks and uncertainties, including those identified below, which could cause actual results to differ materially from historical results or those anticipated. The words "believes," "anticipates," "plans," "may," "intend," "estimate," "will," "should," "could," "feels," "is optimistic," "expects," and other expressions which indicate future events and trends also identify forward-looking statements. However, the absence of such words does not mean that a statement is not forward-looking.

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The future operating results of the Company are subject to various risks and uncertainties and could differ materially from those discussed in the forward-looking statements and may be affected by various trends and factors which are beyond our control. These risks and uncertainties include, among other factors, general business and economic conditions, rapid technological changes accompanied by frequent new product introductions, competitive pressures, dependence on key customers, the attainment of design wins and obtaining orders as a result, fluctuations in quarterly and annual results, the reliance on a limited number of third party suppliers, limitations of our manufacturing capacity and arrangements, the protection of our proprietary technology, the dependence on key personnel, changes in critical accounting estimates, potential impairments related to goodwill and investments, and foreign regulations. These statements should be read in conjunction with the audited Consolidated Financial Statements, the Notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations of the Company as of December 31, 2005, as reported in its Annual Report on Form 10-K, and other documents filed with the Securities and Exchange Commission. Additional information related to risk factors can be found in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Stockholders are cautioned not to place undue reliance on the forward-looking statements which speak as of the date of this quarterly report or the date of the documents incorporated by reference in this quarterly report.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's assets are exposed to various market risks in the normal course of business, primarily interest rate risk and changes in the market value of our investments and we believe the exposure to such risk is minimal. Investments are made in accordance with the investment policy and primarily consist of auction rate municipal securities. The Company's assets are also subject to foreign exchange risk related to our operations in Canada. We believe that the exposure to foreign currency risk is minimal for the first nine months of 2006. Management does not enter into the investment of derivative financial instruments.

### ITEM 4. CONTROLS AND PROCEDURES

#### A. Evaluation of Disclosure Controls and Procedures

The Company's Chief Executive Officer and its Chief Financial Officer have evaluated the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this quarterly report. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of such date.

#### B. Changes in Internal Control Over Financial Reporting

There has been no change in the Company's internal control over financial reporting that occurred during the fiscal quarter covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 6. EXHIBITS

31.1 Certification of Chief Executive Officer

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31.2 Certification of Chief Financial Officer  
32.1 Section 1350 Certification

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PERFORMANCE TECHNOLOGIES, INCORPORATED

November 7, 2006

By: /s/ John M. Slusser  
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John M. Slusser  
Chairman of the Board, Interim President and  
Chief Executive Officer

November 7, 2006

By: /s/ Dorrance W. Lamb  
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Dorrance W. Lamb  
Chief Financial Officer and  
Senior Vice President

Exhibit 31.1

Certification of Chief Executive Officer

I, John M. Slusser, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Performance Technologies, Incorporated;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

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- a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2006

By:/s/ John M. Slusser

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John M. Slusser  
Interim Chief Executive Officer

Exhibit 31.2

Certification of Chief Financial Officer

I, Dorrance W. Lamb, certify that:

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1. I have reviewed this quarterly report on Form 10-Q of Performance Technologies, Incorporated;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

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- b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2006

By:/s/ Dorrance W. Lamb

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Dorrance W. Lamb  
Chief Financial Officer

Exhibit 32.1

Section 1350 Certification

Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 ("Section 906"), John M. Slusser and Dorrance W. Lamb, the Interim Chief Executive Officer and Chief Financial Officer, respectively, of Performance Technologies, Incorporated, certify that (i) the quarterly report on Form 10-Q for the quarter ended September 30, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) the information contained in such report fairly presents, in all material respects, the financial condition and results of operations of Performance Technologies, Incorporated.

A signed original of this written statement required by Section 906 has been provided to Performance Technologies, Incorporated and will be retained by Performance Technologies, Incorporated and furnished to the Securities and Exchange Commission or its staff upon request.

Date: November 7, 2006

By:/s/ John M. Slusser

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John M. Slusser  
Chairman of the Board, Interim President  
and Chief Executive Officer

Date: November 7, 2006

By:/s/ Dorrance W. Lamb

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Dorrance W. Lamb  
Chief Financial Officer and  
Senior Vice President